

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
SALVATORE J. MARINO, JR.) No. 91A-0934-TL
)

Appearances:

For Appellant: Jennifer Miller Moss,
Attorney at Law

For Respondent: Edward J. Kline,
Senior Tax Counsel

OPINION

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Salvatore J. Marino, Jr., against proposed assessments of additional personal income tax in the amounts of \$7,406 and \$975 for the years 1982 and 1983, respectively, and pursuant to section 19324, subdivision (a),^{1/} of Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Salvatore J. Marino, Jr., for refund of personal income tax in the amount of \$1 or more for the year 1981.

^{1/} Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The issues to be decided in this appeal are whether legal expenses incurred by appellant and paid for by his employer should be included in his gross income and whether such amounts are deductible as ordinary and necessary business expenses.

Appellant was an employee of California Cheese Company (the Company). The Company was a closely held, family business. Its shares were held in a trust. Appellant was one of the beneficiaries and his father, Angelo, retained voting power over the shares. Angelo Marino was also a director and the president of the Company.

Appellant and Angelo Marino were charged with the murder, attempted murder, and kidnapping of two individuals, Peter Catelli and Orlando Catelli, on October 11, 1977, at the Company's premises. Peter Catelli (decedent)^{2/} had applied for a job as a painter at the Company and interviewed with Angelo Marino. Apparently, when the decedent was rejected, he attempted to extort \$100,000 from Angelo Marino and made threats against him and his family. Appellant was not aware of these threats and the extortion attempt until that fateful night when he walked in on a "settlement conference" between the decedent, the decedent's father (Orlando Catelli), and Angelo Marino and allegedly committed the acts with which he was charged. After several trials, appellant was convicted of murder and attempted murder by a Santa Clara jury in 1991.^{3/}

The Company paid the legal fees and expenses incurred by appellant and Angelo Marino as a result of the ensuing criminal proceedings. The respondent determined the payment of these legal fees to be income and, accordingly, issued notices of proposed assessment (NPAs) to appellant and Angelo Marino.^{4/} Angelo Marino died in 1983, and respondent withdrew its NPAs with respect to him, conceding that he incurred the legal expenses in protecting the good name and reputation of the Company and, thus, the legal expenses were ordinary and necessary business expenses. Appellant contends that, as an officer of the Company, he should be accorded similar treatment. Respondent contests appellant's claim of being an officer of Company, pointing to the Company's corporate tax returns, which do not list appellant as a salaried officer for the years in question, and to appellant's own personal income tax returns, which list his occupation as an administrative assistant. In the alternative, appellant argues that reimbursement for the legal expenses was a gift from Angelo Marino.

During the hearing, appellant made a motion to consolidate the appeal of the denial of a refund claim for 1981, which is based on these same issues. Respondent did not object to the consolidation request, and the motion was granted. After the hearing, the parties submitted a stipulation

^{2/} At the hearing, appellant indicated that decedent worked for the FBI. It is unclear whether appellant meant decedent was an FBI informant, an FBI agent, or worked for the FBI in a clerical or janitorial capacity.

^{3/} The conviction was affirmed by the Sixth District Court of Appeal (California) in May 1994, and on September 8, 1994, appellant's petition for review was denied by the California Supreme Court.

^{4/} In a correlative matter, respondent denied a deduction for Angelo and Salvatore Marino's legal expenses to the Company's transferee.

finalizing the proper amount of legal fees to be apportioned to appellant, thereby modifying the deficiencies asserted by respondent in its NPAs.

Generally, gross income includes all income, from whatever source derived. (See I.R.C. § 61; Rev. & Tax. Code, § 17071.) Before income can be recognized, the taxpayer is required to realize an accession to wealth and have control thereof. (Commissioner v. Glenshaw Glass Co., 348 U.S. 426 [99 L.Ed. 483] (1955).) In addition, a taxpayer recognizes income if he realizes an economic gain and that gain primarily benefits him personally. (United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968).) Moreover, it is well settled that the discharge by the employer of the taxpayer's obligation is equivalent to the receipt of income by that taxpayer. Payment, even if voluntary, for services rendered is taxable compensation to the employee. (Old Colony Trust Co. et al. v. Commissioner, 279 U.S. 716 [73 L.Ed. 918] (1929).) Furthermore, legal fees, paid by another on behalf of a taxpayer, are income to the taxpayer. (O'Malley v. Commissioner, 91 T.C. 352 (1988); Matula v. Commissioner, 40 T.C. 914 (1963).)

We agree with appellant's contention that since appellant was not a shareholder of the Company, the payment of his legal expenses could not be a constructive dividend, as originally asserted by respondent.^{5/} But this only addresses the issue of the characterization of the payment, not whether it is includible in gross income. While this appeal is a case of first impression for us, it is clear from the U.S. Supreme Court's decision in Old Colony Trust Co. and related cases cited hereinabove that appellant must recognize income upon the payment of his legal expenses by the Company.

Relying on Glenshaw Glass Co., appellant admits to having realized an accession to wealth, but denies having any control over the sums expended, the attorneys selected, the hotel stayed in,^{6/} and any choice in the dealings with the prosecutor, and that he only received an incidental benefit. However, it is undisputed that an attorney owes his allegiance to the client, not to the fee payer. If appellant wanted to plea bargain or wanted to plead guilty by reason of insanity, he could have instructed his attorney to do so and his attorney would have had to abide by those wishes, notwithstanding the Company's and/or Angelo Marino's instructions to the contrary. Furthermore, since it is appellant, and not the Company, who was indicted, he is necessarily the primary beneficiary of these payments. (See Pantages Theatre Co. v. Welch, 71 F.2d 68 (9th Cir. 1934).)

Appellant further relies on United States v. Gotcher, supra. In that case, the taxpayer, who was an employee of a Volkswagen dealership, and his wife were sent on an all-expense paid trip to Germany by his employer. While in Germany, the taxpayer toured Volkswagen plants and facilities to learn more about its operations. Volkswagen wanted to demonstrate the quality of its product and the stability of the German economy in the hopes the taxpayer would eventually invest in a

^{5/} Apparently, respondent's original position was based on Jack's Maintenance Contractors, Inc. v. Commissioner, 703 F.2d 154 (5th Cir. 1983), where the payment by a corporation of its sole shareholder's legal fees to defend charges of criminal tax evasion was deemed to be a constructive dividend to the shareholder and not deductible as an ordinary and necessary business expense by the corporation. See infra note 10 for a further discussion of this case.

^{6/} Due to the amount of publicity surrounding the trial, a change of venue was ordered.

Volkswagen dealership in the United States. In rejecting the Internal Revenue Service's (IRS) assertion that the cost of the trip was income to the taxpayer, the Fifth Circuit found the trip to be primarily for the business and convenience of the taxpayer's employer, and the taxpayer received only an incidental personal benefit. However, as noted above, appellant, being the client, is the primary beneficiary of the legal fees, not the Company.^{7/} Thus, Gotcher is not applicable. Ironically, appellant's position is more akin to that of the taxpayer's wife in Gotcher, whose deficiency resulting from her share of the costs of the Germany trip was sustained by the court.

Issue was taken at the hearing with respect to the characterization of this income, especially since respondent disallowed the Company's deduction for these payments. While we believe this is a moot point because of the broad definition of gross income, the answer can be quite simply this: Appellant was a beneficiary of the trust which owned the Company's shares. Hence, the payment can be construed as a constructive dividend payout to the trust, followed by a constructive distribution from the trust to appellant.^{8/} Appellant's alternative claim that the legal fees were a gift from Angelo Marino is unsubstantiated, with no showing of donative intent, and is, thus, of no consequence. (See Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949).)

Nevertheless, the above analysis will be of little import if we find the legal fees to be ordinary and necessary business expenses, thereby permitting appellant to virtually wipe out the proposed deficiency with a corresponding deduction. A taxpayer may take a deduction for ordinary and necessary business expenses. (I.R.C. § 162(a); Rev. & Tax. Code, § 17202.) However, personal expenses are not deductible. (I.R.C. § 262; Rev. & Tax. Code, § 17282.) Litigation expenses are deductible if the lawsuit against the taxpayer arises in connection with the taxpayer's profit-seeking activities. (United States v. Gilmore, 372 U.S. 39, 48 [9 L.Ed.2d 570] (1963).) Since federal income tax provisions governing this area are substantially similar to their California counterparts, we are entitled to rely on federal court decisions interpreting them in making our determination. (See Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Appeal of Glenn M. and Phyllis R. Pfau, Cal. St. Bd. of Equal., July 31, 1972.)

There are two U.S. Tax Court cases which we find to be extremely relevant to this appeal. In the first case, the taxpayers and one of their employees were indicted, and subsequently acquitted, of killing a man over the breach of a contract to haul wood from the decedent's property; the taxpayers operated a cotton plantation and several other businesses as a partnership, and the wood was to be used in that business. The IRS disallowed deductions for legal fees incurred during the criminal action and costs to settle the resulting wrongful death action. In upholding the IRS' determination, the U.S. Tax Court ruled the homicide was not directly related to or proximately caused by the breach of contract, and the acts were not within the scope or duties of their employment. Therefore, the expenses were personal, and the taxpayers' acts were not ordinary either to their business or business in general. (See Sturdivant v. Commissioner, 15 T.C. 880 (1950).)

^{7/} See Jack's Maintenance Contractors, Inc. v. Commissioner, 703 F.2d 154 (5th Cir. 1983), discussed infra at note 10.

^{8/} The trust provides that its trustees have discretionary power to distribute income and principal to the beneficiaries.

In the second case, the taxpayer went to his estranged wife's home to get her signature on their joint federal income tax return. While there, he got into an altercation with his wife's brother and sister-in-law, whereby the taxpayer shot and killed both of them; the taxpayer was tried for murder but was acquitted. In attempting to deduct his legal fees, the taxpayer argued that they "were necessary to the continuation of his business, and that had he been unable to successfully defend himself against said charges his business would have been entirely destroyed." In finding the expenditures were personal rather than business, the U.S. Tax Court traced the origin and character of the controversy, as required by United States v. Gilmore, supra. (See Hylton v. Commissioner, ¶ 73,262 T.C.M. (P-H) (1973).) In Gilmore, the U.S. Supreme Court held that in determining whether legal costs are ordinary and necessary business expenses, the focus must be on whether they arise in connection with the taxpayer's profit-seeking activities, and not on the effects to a taxpayer's income-producing property that might result from a failure to defeat the claim.^{9/}

These cases lead us to the inescapable conclusion that appellant's legal costs cannot be deemed to be ordinary and necessary business expenses. They also provide us with ample fodder to dispose of one of the major points of contention in this appeal - i.e., whether appellant was an officer of the Company and so closely identified with it that any acts attributable to him would adversely affect the Company's reputation, as appellant claims, or whether appellant was merely an employee of the Company, as respondent claims. Appellant's position at the Company is only relevant if we have to consider the impact to the Company following a conviction. But, Gilmore and Hylton hold we need only look to the origin and character of the claimed deductions to see whether they arise from the taxpayer's profit-seeking activities.

In this regard, appellant also contends the entire chain of events leading up to the night of October 11, 1977, evolved from the interview at the Company of Peter Catelli, who appellant had met briefly and had a cup of coffee with before Catelli met with Angelo Marino. In support of his position, appellant relies on essentially two cases - Commissioner v. Tellier, 383 U.S. 687 [16 L.Ed.2d 185] (1966), and Clark v. Commissioner, 30 T.C. 1330 (1958). Tellier involved a securities dealer who deducted legal fees connected to his unsuccessful defense against criminal charges of securities and mail fraud. In Clark, the taxpayer was charged with assaulting, with intent to rape, a prospective employee during a job interview. The charge was subsequently dropped and the taxpayer deducted legal fees and costs associated with the criminal proceedings and settlement of the anticipated civil action. The courts in both of these cases allowed the claimed deductions as ordinary and necessary business expenses. However, the instant appeal is clearly distinguishable.

In Tellier, the IRS had already conceded the legal fees were ordinary and necessary business expenses. The only relevant issue remaining for the Court to decide was whether allowing the claimed deductions violated public policy. The Clark opinion conflicts with the Ninth Circuit's decision

^{9/} In Gilmore, the Court found that legal expenses incurred during a divorce proceeding to determine whether stock in three corporations, of which taxpayer was president and manager, was community property were not ordinary and necessary business expenses.

in Pantages Theatre Co. v. Welch, 71 F.2d 68 (9th Cir. 1934). In Pantages, the court held that legal expenses incurred by the corporation in defense of its president, founder, and managing head, Alexander Pantages, who was charged with the rape of a job applicant during an interview, were not deductible as ordinary and necessary expenses. The court found the crime charged was purely personal, was not by or for the corporation, and did nothing to advance the business of the corporation.

In this case, appellant did not participate in the interview and, by his own admission, was not aware of the extortion attempt and threats against the Marino family until the night of the murder. Thus, it cannot be said the criminal acts arose out of and proximately resulted from the legitimate business activities of appellant. (Cf. Clark v. Commissioner, supra.) If appellant had been, for example, a security guard and committed the crimes either in self-defense or in the defense of another, then perhaps we could entertain a claim of ordinary and necessary business expense. Otherwise, we know of no enterprise where killing someone is a legitimate business activity. Because of the similarities to Hylton and Sturdivant, and because of the courts' rejections of the taxpayers' claims of acting in furtherance of their businesses in those cases, including the Pantages case, we cannot find that appellant's legal fees constitute ordinary and necessary business expenses.

The decisions in Pantages, Hylton, Sturdivant, and Jack's Maintenance Contractors, Inc. v. Commissioner, supra,^{10/} also serve another purpose. All these cases involve taxpayers who had their own businesses, some in their own name, and were charged with criminal acts. In each of these instances, the court ignored the taxpayer's "key-man" status in his respective business, and we do so here. Thus, as mentioned above, whether appellant was an officer or a rank and file employee of the Company is irrelevant to our determination.

Finally, appellant points to the inconsistent treatment between himself and his father. We do not pretend to understand why respondent was so generous with Angelo Marino; perhaps it was trying to be in conformity with Parker v. Commissioner, 365 F.2d 792 (8th Cir.), cert. den., 385 U.S. 1026 [17 L.Ed.2d 674] (1967). In that case, a religious foundation was allowed to deduct, as ordinary and necessary business expenses, legal fees incurred in the defense of its primary functionary (a reverend) on criminal charges of contributing to the delinquency of a minor. There, the court found the functionary was so closely identified with the foundation that the acts of the individual could be attributed to the entity.

By appellant's own admission, Angelo Marino was the key-man at the Company; he was the captain of the ship and "ran the show." That being the case, appellant's position at the Company could not amount to anything more than being a member of the bridge crew, for it would be improvident for any ship to have more than one captain. Simply put, if Angelo Marino was California

^{10/} See supra note 5. The shareholder in this case was also not allowed to deduct his legal fees as a business expense. The tax evasion charges arose from the shareholder's failure to report receipts from the taxpayer during the years it was operated as a sole proprietorship. In so ruling, the court found the relative benefits to the shareholder of staying out of prison far outweighed those to the corporation of staying in business and, thus, the shareholder, not the corporation, was the primary beneficiary of the payment. Hence, the legal fees were personal expenses. (The IRS subsequently dropped the criminal tax evasion charges.)

Cheese Company, appellant could not be. Thus, unlike Angelo Marino, it cannot be said the acts of appellant could be construed to be the acts of the Company.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Salvatore J. Marino, Jr., against proposed assessments of additional personal income tax in the amounts of \$7,406 and \$975 for the years 1982 and 1983, respectively, and pursuant to section 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Salvatore J. Marino, Jr., for refund of personal income tax in the amount of \$1 or more for the year 1981, be and the same is hereby modified to reflect the adjustments shown on the stipulation filed by the parties on January 20, 1994. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 7th day of December, 1994, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Jr., and Ms. Scott present.

Brad J. Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

_____, Member

- For Gray Davis, per Government Code section 7.9.